

THE *Dan Smoot Report*



DAN SMOOT

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TAX REFORM — PART 1

On August 7, 1969, the House, by a roll-call vote of 394 to 30, passed HR 13270, the Tax Reform Act of 1969.

The bill grew out of publicity about 154 taxpayers, with gross incomes of \$200,000 or more each, who paid no federal income taxes for the year 1966.

None of the 154 has been, or will be, prosecuted. They did not cheat. They merely took advantage of legal tax-avoidance provisions in existing federal tax laws. They escaped paying federal income taxes in 1966 because their legitimate deductions exceeded their taxable incomes that year. The deductions were for business-operating losses during the year; for large tax payments to local and state governments; for interest paid on money borrowed to finance investments and business operations; for donations to organizations (charitable, educational, and otherwise) to which the federal government has given the special privilege of tax exemption.⁽¹⁾

The legislative history of the Tax Reform Act of 1969 is rather good evidence that political propaganda rather than desire for elimination of tax inequities was the motivating force behind the legislation.

The bill was written by the House Ways and Means Committee. Committee hearings on the measure fill 15 large printed volumes. Other Members of Congress were given little opportunity to study the hearings. The bill itself fills 368 pages with fine print. Together with a 226-page report by the Ways and Means Committee, and a 143-page supplemental report, the 368-page Tax Reform Act of 1969 was made available to Members of the House only three days before they took their final vote to pass it. The bill was debated only two days in the House, and was submitted for a vote under a closed rule which prohibited Members from offering amendments from the floor.⁽²⁾

Congressmen could not possibly have known what was in the massive tax bill they passed. Many, if

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not most, who voted for it were obviously motivated solely by political reasons. The public had been led to believe that the Tax Reform Act would actually eliminate inequities in existing tax law, and make the super-rich pay their "fair share" of taxes, thus easing the load on taxpayers with low or moderate incomes. There are many times more votes to be had by catering to taxpayers with low and moderate incomes than by catering to those who are rich.

But the Tax Reform Act of 1969 will not soak the rich. It is always the great mass of taxpayers, with low and moderate incomes, who carry most of the income tax burden. In fact, if government confiscated all of the income of all the super-rich, it would not thereby get enough revenue to finance present government programs for more than a day or two, because the number of super-rich is relatively small.

The Tax Reform Act of 1969 will not decrease the numbers of inequities in the tax law, but increase them. It will not decrease the total tax burden on the public, but shift it around a bit and make it heavier. It will not simplify the tax code, but multiply its absurd complexities.

Our federal income tax system is full of inequities. It grants special privileges (some to poor people, some to rich), and gives total tax exemption to rich and powerful organizations (like unions, foundations, and cooperatives) which operate continuously as clamorous lobbies for higher taxes on those who are not exempt from paying.

Practically every time Congress tries to patch up this monstrous system, however, it makes matters worse.

Consider, for example, provisions in the Tax Reform Act of 1969 changing the accelerated-depreciation privileges now enjoyed by owners of certain kinds of income-producing buildings. President Nixon approves the basic provisions of this section of the Tax Reform Act of 1969, and so does the Senate Finance Committee.⁽³⁾ The

government expects this section of the law to cost the real estate industry about \$1 billion a year more in federal income taxes than the industry has been paying. This will be the biggest "loophole" closed by the Tax Reform Act. No other single industry or interest will be so heavily affected by the bill.⁽³⁾

Depreciation allowances for real estate are based on the theory that buildings decline in value as they grow older. A man builds a building and rents it out. He is taxed on the rental income. Yet, the value of the man's investment declines every year, because his building depreciates in value by virtue of growing older.

Years ago, Congress tried to take these economic facts into account by permitting the owner of an income-producing building to deduct from his annual rental income his annual loss through aging of the building. Some buildings, of course, lose value through aging faster than others. But congressional tax writers could not take into account such infinite variations. They compromised on an arbitrary formula, and applied it to all income-producing buildings. They assumed that the normal life of such a building is 40 years. Hence, if a man puts up a \$40,000 income-producing building, it depreciates \$1000 a year in value through aging. Consequently, the owner was permitted to deduct \$1000 a year from his taxable income for 40 years. If he sold the building, the subsequent owner could deduct \$1000 a year for depreciation loss until the building was 40 years old.

All of this is, of course, discriminatory against other categories of real estate owners — those who build or buy their own homes, or other kinds of buildings not used for income-producing purposes.

But all *income* taxes are inescapably inequitable and discriminatory. There is no way to levy *income* tax without treating some types of income differently from other types, or without giving some categories of taxpayers special privileges not given to others.

Depreciation of income-producing buildings at the rate of 2.5% a year for forty years is known, in income-tax jargon, as "straight-line" depreciation; and it is still in effect on income-producing buildings which were erected (or sold to present owners) before 1954, and which are still under 40 years old. Depreciation is also allowed for other types of property used for income-producing purposes (automobiles, office equipment, and so on) — the term of years for each type depending on the formula fixed by Congress as being the normal life of such property. When accelerated depreciation was adopted, it also was granted to other types of property besides real estate; but accelerated depreciation for real estate is of most importance. It is now considered *the* loophole that needs closing.

In 1954, Congress purposefully granted this loophole ("fast write-off" or "accelerated depreciation" privilege) to the real estate industry. The tax formula for accelerated depreciation is too complicated for one layman to explain to another. And this indicates one reason why the people oppressed by the income-tax system cannot effectively fight it by exposing its inequities: Most do not understand the inequities, and those who do cannot explain them adequately to others.

But let us try. The accelerated depreciation authorized by Congress in 1954 still requires an income-producing building to be depreciated over a 40-year period, but permits larger amounts to be deducted for depreciation in the early years of the life of the building. For example, if a man erects a \$40,000 income-producing building, he may take double (200% of) the amount of straightline depreciation on the declining balance. The first year, instead of deducting \$1000 for the aging of his building, he may deduct \$2000. The second year, his depreciation deduction is 5% (two times 2.5%) of \$38,000, or \$1900. The third-year depreciation deduction on the building is 5% of \$36,100 (or \$1805) — and so on, for 40 years. If the building is sold, the subsequent owner or owners may take accelerated depreciation of 150% (instead of 200%) of the straight-line depreciation.

Congress added the fast write-off provisions to the 1954 revenue code for the purpose of helping small businesses and stimulating the economy.⁽⁴⁾

I was opposed to the provisions at the time, because any tax law intended to stimulate the economy, or halt inflation, or help the "little man," or penalize the "big man," is a bad law.⁽⁴⁾ It is discriminatory, and it will inevitably deflect human resources and energy from creative and productive activity into tax-avoidance activity.

When someone builds anything, not because there are economic reasons to believe the structure is needed and will therefore be profitable, but because there is a *tax advantage* in that particular kind of investment, he is responding to the pressure of tax laws which have *perverted* economic principles.

The same is true when someone buys a farm, or a near-bankrupt business, as a "good place to take a tax loss"; drills an oil well; buys supplies and equipment; increases inventory; or makes big advertising outlays — not because these expenditures are economically sensible, but because they can effect "tax savings."

Any federal tax levied for any purpose whatever, except to raise the minimum amount of revenue which government must have to perform its constitutional functions, perverts and distorts the economy of the nation. The damaging effects are often so subtle and long-range that they are difficult to perceive until after the event.

This is precisely what happened as a result of the fast write-off provisions of the 1954 revenue code. The provisions enabled a builder to write off almost one-fourth of his total investment in five years. This did not primarily help the little businessman, as planned. It helped wealthy builders who could put up expensive structures, operate them for five years while they were new and required minimum maintenance, skim off the cream of the tax write-off benefits, sell out at a profit, and then build more new buildings in order to get fast write-off.

Within four years after the 1954 revenue code went into effect, the American hotel business was approaching a condition similar to that of the 1930's when most major American hotels went into receivership. On Miami Beach, for example, many fabulous resort hotels were on the verge of bankruptcy, struggling for refinancing, being sold for a fraction of original cost — while, at the same time, new, and more elaborate, motels and hotels were being built nearby. This sort of thing was happening all over the country.⁽⁴⁾

The over-building (which bankrupted many downtown hotels and left the transient-lodging business largely with new motels scattered through the suburbs and on the edges of cities) was caused by the fast write-off provisions of the 1954 revenue code. The tax law encouraged building which provided bountiful tax advantages for the builders, but which the economy did not need.⁽⁴⁾

Eventually, rising costs of labor, material, interest, and taxes slowed down the over-building boom; and the real estate industry adjusted itself to the effects of the fast write-off tax provisions. The industry is presently geared to the federal tax law under which it has been operating for 15 years.

Now, the Tax Reform Act of 1969 will distort and disrupt the economy again by changing the fast write-off provisions. The law will continue the 200% depreciation rate for income-producing *residential* real estate, but reduce it to the 150% level for all other new income-producing real estate. All used real estate presently eligible for the 150% depreciation rate will be cut back to ordinary straight-line depreciation.⁽⁵⁾

This is no reform. Many who are already committed to types of building not favored by the new tax law will be hurt. Those able to move immediately into the kind of building that the new tax law favors will make huge profits. There will be over-building and bankruptcies in some categories of the industry, under-building and bankruptcies in others. The "tax reform" will

again create havoc in the real estate industry but, in the end, will not produce the additional \$1 billion in taxes that the tax writers anticipate. Big operators will manage to concentrate on the kind of building that the new tax law favors.

Our federal income tax system is a corrupter and despoiler of the people. It is inequitable and unfair because it was intended to be inequitable and unfair. Indeed, it is humanly impossible to write a tax on *incomes* that does not penalize some taxpayers while granting special benefits to others. Consequently, it is quite impossible to *reform* our federal income tax system.

To achieve fairness in taxation, and save America from becoming a bankrupt socialist-communist nation, we must abolish the federal income tax and adopt a different kind of taxing system.

NEXT WEEK: More on this subject.

FOOTNOTES

- (1) "Those Tax-Free Millionaires," *U.S. News & World Report*, Oct. 20, 1969, p. 80
- (2) "Shortsighted Tax Reform Bill," Henry Hazlitt, *Human Events*, Aug. 30, 1969, p. 600
- (3) "Real Estate Hit," *Dallas Morning News*, Oct. 21, 1969, p. A20
- (4) *Dan Smoot Report*, May 16, 1960
- (5) *Congressional Quarterly Weekly Report*, Aug. 8, 1969, p. 1427

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